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# Inversions: Is This the End?

On Monday, September 22, 2014, the Treasury and IRS issued Notice 2014-52 (the "Notice"), which makes corporate inversions more difficult to accomplish and diminishes the economic benefit of inverting. The guidance described in the Notice will apply to inversions completed on or after September 22, 2014.

## Corporate Inversions (Before the New Guidance)

A corporate inversion involves the conversion of a U.S. parent company of a multinational corporate group into a non-U.S. parent company. In an inversion transaction, a U.S. company and a non-U.S. merger partner typically transfer their operations to a new non-U.S. parent, which is jointly owned by the combining companies' shareholders. The new non-U.S. parent is usually domiciled in a jurisdiction that offers, among other things, status as an international business center and a favorable tax regime. The new structure allows the multinational corporate group to minimize its exposure to U.S. corporate taxes.

Under the anti-inversion rules before the Notice, a corporate inversion would normally be respected, if either of two tests is satisfied:

- 80% Test: The transaction results in less than 80% (by vote and value) of the new non-U.S. parent being held by the former shareholders of the U.S. company; or
- Business Activities Test: After the transaction, the new non-U.S. multinational corporate group conducts substantial business activities in the home country of the new non-U.S. parent.

If neither of these requirements is satisfied, then the transaction would not be respected for U.S. tax purposes. The new non-U.S. parent would be treated for U.S. tax purposes as a U.S. corporation—that is, it would be subject to U.S. corporate income tax on its worldwide income, including dividends from non-U.S. subsidiaries and gain on sale of non-U.S. subsidiaries.

## What Has Changed?

The Notice makes it more difficult to accomplish a corporate inversion and escape U.S. taxation.

**Harder to satisfy the 80% Test.**

- The test depends on the relative equity values of the U.S. company and its non-U.S. merger partner. The smaller the U.S. company's value is compared to the value of the merger partner, the easier it is to meet the 80% Test. Under the Notice, if the U.S. company tries to reduce its equity value by making extraordinary distributions to its shareholders during the 3 years preceding an inversion, those distributions are ignored for purposes of measuring the U.S. company's equity value and applying the 80% Test. Also, if over 50% of the non-U.S. merger partner's assets are passive, then the non-U.S. merger partner's equity value generally excludes the amount of those assets.
- The Notice also cracks down on "spinversion" transactions (in which a U.S. company is acquired by a non-U.S. subsidiary of a U.S. parent, and the U.S. parent then distributes shares of the non-U.S. acquiring company to its shareholders). Such transactions will no longer satisfy the 80% Test under the Notice.

**Limiting the benefit of an inversion.**

- Loans from CFCs to Non-U.S. Parent. After an inversion, the U.S. company typically continues to own shares in its non-U.S. subsidiaries ("controlled foreign corporations" or "CFCs"). However, the U.S. company could avoid paying U.S. corporate tax on the CFCs' earnings by having the CFCs make loans to the non-U.S. parent company (or buy shares of the non-U.S. parent), rather than pay dividends to the U.S. company. Under the Notice, if such a loan or share purchase is made by a CFC within 10 years after the inversion, then the amount loaned or paid is deemed to be a dividend to the U.S. company.
- Non-U.S. Parent's Direct Investment in CFCs. The Notice attacks post-inversion transactions in which the new non-U.S. parent contributes assets to CFCs of the U.S. company in exchange for an issuance of shares of those CFCs, thus substantially diluting the U.S. company's ownership of the CFCs. Prior to the Notice, dividends paid by such CFCs directly to the non-U.S. parent would generally escape U.S. corporate tax. The Notice, however, provides that where such a restructuring transaction occurs within 10 years after an inversion, the dividends paid directly to the non-U.S. parent are deemed to have been paid to the U.S. company, with such U.S. company being subject to U.S. corporate tax on the dividends.
- Other Strategies. The Notice also blocks other, more complex strategies to extract profits of the U.S. company's CFCs after an inversion.

# What Is Left?

Perhaps at least partly out of concerns about limits on Treasury's and the IRS's statutory authority, the Notice does not limit some key advantages of a successful inversion:

- *New Non-U.S. Operations Under the Non-U.S. Parent.* The non-U.S. parent is free to hold directly (or through non-U.S. subsidiaries) any new non-U.S. operations, and directly (or through non-U.S. subsidiaries) make future non-U.S. acquisitions. The profits of those operations or acquired companies will not be subject to U.S. corporate tax.
- *Sell or Distribute CFC Stock.* The former U.S. parent can sell its interest in (or distribute) its CFCs to the new non-U.S. parent. The gain recognized from such transaction will be subject to U.S. corporate tax at the time of such transaction; but post-transaction profits will be free of U.S. corporate tax.
- *Earnings Stripping.* Subject to the general earnings-stripping rules, a U.S. company can reduce its U.S. tax base by making deductible payments to the non-U.S. parent (interest, royalties, etc). The Treasury has said that it is reviewing whether and how the current earnings-stripping rules should be changed (and whether changes would require Congressional action). The Notice indicates that any future changes regarding how the earnings stripping rules apply to inverted companies will affect all inversions occurring on or after September 22, 2014.

# Takeaways

- Inversions occurring before September 22, 2014 are grandfathered from almost all the above rules. However, there is no grandfather rule for inversions announced before, but completed after, that date.
- The projected benefits of some planned inversions may need to be re-priced. It will be harder for future transactions to meet the 80% Test; and the benefits of doing so will be less.
- Nevertheless, some of the main advantages of an inversion largely remain intact.
- The changes in the 80% Test may mean that in future inversions, shareholders of the U.S. company will sometimes receive more cash, and less stock of the non-U.S. parent.

# Tax contacts

**Richard Catalano**

Partner
T: +1 212 878 8421
E: richard.catalano
@cliffordchance.com

**David Harkness**

Partner
T: +44 20 7006 8949
E: david.harkness
@cliffordchance.com

**Nick Mace**

Partner
T: +44 20 7006 4679
E: nicholas.mace
@cliffordchance.com

**David Moldenhauer**

Partner
T: +1 212 878 8384
E: david.moldenhauer
@cliffordchance.com

**Philip Wagman**

Partner
T: +1 212 878 3133
E: philip.wagman
@cliffordchance.com

# M&A contacts

**Gary Boss**

Partner
T: +1 212 878 8063
E: gary.boss
@cliffordchance.com

**David Brinton**

Partner
T: +1 212 878 8276
E: david.brinton
@cliffordchance.com

**Joseph Cosentino**

Partner
T: +1 212 878 3149
E: joseph.cosentino
@cliffordchance.com

**John Graham**

Partner
T: +1 212 878 4955
E: john.graham
@cliffordchance.com

**John Healy**

Partner
T: +1 212 878 8281
E: john.healy
@cliffordchance.com

**Sarah Jones**

Partner
T: +1 212 878 3321
E: sarah.jones
@cliffordchance.com

**Robert Masella**

Partner
T: +1 212 878 8076
E: robert.masella
@cliffordchance.com

**Guy Norman**

Partner
T: +44 20 7006 1950
E: guy.norman
@cliffordchance.com

**Mark Poulton**

Partner
T: +44 20 7006 1434
E: mark.poulton
@cliffordchance.com

**Ivan Presant**

Partner
T: +1 212 878 3154
E: ivan.presant
@cliffordchance.com

**Patrick Sarch**

Partner
T: +44 20 7006 1322
E: patrick.sarch
@cliffordchance.com

**Benjamin Sibbett**

Partner
T: +1 212 878 8491
E: benjamin.sibbett
@cliffordchance.com